SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

A8825-2

Securities Industry Association
120 Broadway
New York, New York 10271

Phone (212) 608-1500

Annual Subscription
$40.00 member • $60.00 non-member
$72.00 subscribers outside U.S. and Canada

Vol. XIII, No. VI

August 31,1990

The Party's Over?

The attractiveness of the U.S. markets to foreign investors in the 1990s appears to be on the wane, in sharp contrast to the 1980s, when foreign investors made record investments in U.S. securities. Given economic and political developments in Europe, and the global unease about the U.S. economy, foreign investors have, for the most part, stayed away from U.S. portfolio investments. Perhaps, those who warn against the evil of foreign investment may be relieved by this turn of events. However, the consequences for U.S. markets are real, higher interest rates and lower equity prices, to name just two.

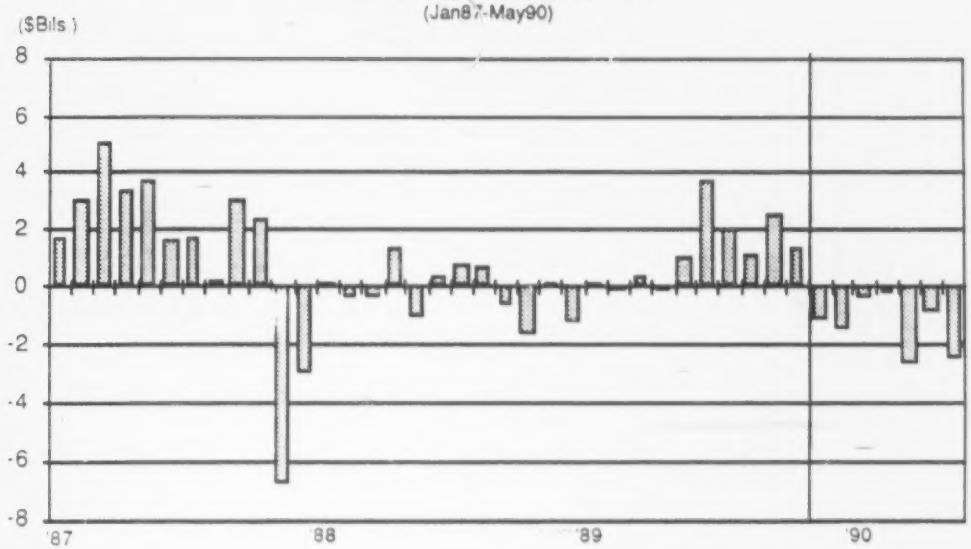
Foreign Net Activity In U.S. Securities

($Bils.)

	Jan-May 90	*Jan-May 89*
Equities	(6.7)	1.3
Treasuries	(5.9)	27.3
Corp. Bonds	5.5	8.4
U.S. Agencies	2.8	5.3
Total	(4.3)	42.3

In the last *FAR*, we noted that the U.S. experienced net foreign outflows for the first time since 3Q83. Preliminary data for April and May 1990 show foreign investors continue to shun U.S. securities. Foreign portfolio inflows totalled a meager $167 million during April and May. In large part, the positive direction of the flow results from net purchases of $2.3 billion in corporate bonds. While, in total, foreign investors also nibbled at U.S. Treasuries, with net purchases of $576 million, private investors made net sales of $2.1 billion.

Foreign Net Activity in U.S. Equities:
Can't They Spare Us A Dime



While net foreign investment in U.S. equities had been erratic in the post-crash era, a steady pattern of buying developed during May to October 1989. Since then, equities have fallen on hard times. After divestitures of $3.3 billion in 1Q90, net sales totalled an additional $3.4 billion for April and May. Indeed, foreign investors have made net sales for seven consecutive months, totalling $9.3 billion. This is a far cry from their posture during the 1980s.

Strikingly, the depth of the foreign sell-off in the past half-year has been much greater than after the events of October 1987. Certainly, the 1987 environment was different -- a strong U.S. economy, low inflation, an active takeover market and relatively high interest rates attracting foreign investors. However, we also believe a more fundamental shift in the foreign investors' attitudes to U.S. markets are taking place. This viewpoint is relatively more sanguine about the long-term prospects in several foreign equity markets compared to the U.S. market. In contrast, events in October 1987 were seen as short-term phenomenon and, therefore, no reason to significantly reduce U.S. holdings.

In fact, foreign investors had become a growing factor in the U.S. equity market by increasing their demand relative to U.S. investors. Foreign investors were an important foundation for U.S. equity prices in the 1980s, accounting for over 20% of all net purchases of U.S. stocks. Further underscoring the impact of the foreign investor was the reduction in supply of U.S. equities in the 1980s, which amounted to nearly $450 billion. Put another way, at the same time that foreign investors increased their demand for U.S. equities, the aggregate supply was diminishing giving foreigners an even larger impact on U.S. equity markets. The foreign pullback, combined with a reduction in takeover and corporate buyback activity, means that equities are losing two important pillars of price support in the 1980s.

Foreign Acquisition Of U.S. Equities
($Bils.)

	Institutional	Foreign ($)	Foreign (%)	Supply Of Equities
1980-1989	295.4	**62.5**	**21.2**	-449.4
1970-1979	150.3	**21.5**	**14.3**	78.5
1960-1969	71.8	**5.1**	**7.1**	15.1
1950-1959	18.0	**1.2**	**6.7**	18.0

Source: Federal Reserve; Goldman, Sachs & Co.

Not only has foreign interest in U.S. equities suffered due to new investment opportunities in other countries, but the recent rise in global interest rates has made equity investment less desirable relative to bonds. That this has not caused a shift by foreign investors to U.S. bonds is as much the result of foreign investor concern over the health of the U.S. economy, and the value of the dollar, as it is result of the relatively high interest rates investors can lock-in in their home market (without currency risk), or other foreign markets.

A Case Example: Japanese Investment

Japanese investors were major contributors to the U.S. capital markets in the mid-to-late 1980s. Japanese investors, beset by fears of inflation, rising domestic interest rates, and faltering equity prices have begun to reduce the high levels of overseas portfolio investment which have been common since the Yen/Dollar Agreement in 1984. Domestic concerns, combined with the tremendous growth in the holdings of foreign portfolio assets, suggest reduced portfolio investment in foreign markets over the next few years. In light of the traditional role of the Japanese financial intermediary in introducing Japanese investors to foreign markets, the implication for these firms may well be a squeeze on profit margins and a slowdown in expansion and personnel overseas.

Portfolio Flows

Japanese interest in overseas bonds, particularly U.S. Treasuries, has been widely noted. While their interest in foreign equities has also grown substantially, purchases of bonds clearly outweigh equity purchases. However, during the first quarter of the new decade, Japanese investors made net purchases of only $869 million in all overseas bonds, the lowest level since 1982.

In that the lion's share of Japanese bond purchases have been U.S. fixed income instruments, recent changes in the yield spread help explain the fall-off in bond purchases. Interest rates in Japan seemed to bottom out in April 1988, at below 4.0%. Since that time, however, interest rates have trended upward reaching 7.4% in March 1990, a 340 basis point increase. During this same period, U.S. rates actually declined 15 basis points, from just above 8.6% in April 1988 to 8.45% at the end of March 1990. In other words, Japanese investors now receive only a 100 basis point differential between Japanese and U.S. bond yields compared to over 500 in April 1988. Given the currency risk involved, plus worries over the U.S. inflation rate, U.S. bonds are not an attractive investment to Japanese investors relative to domestic bonds.

Indeed, with yields on U.S. and West German bonds roughly comparable, and with the DM strengthening, Japanese investors may increasingly look at German bonds. Recent events in the Middle East should, at least in the short term, force up interest rates in energy dependent Japan, further narrowing the existing spread between the U.S. and Japanese bond markets.

Moreover, investors from the U.K., Canada, Australia and other countries are finding yields on domestic bonds increasingly attractive. As the table shows, the lure of high yields has shrunk considerably on long-term U.S. Treasuries. For example, only one year ago, U.S. 10-year governments yielded 182 basis points more than German governments; the yield spread has since narrowed to 12 basis points. On bonds of shorter maturity, domestic bonds are even more attractive. Of the seven major investors in U.S. Treasuries, six can "lock-in" higher yields at home, and, for the other, the spread has narrowed considerably in the past year. This yield spread analysis helps explain both the current weakness in the dollar and the Fed's limitation to lower interest rates as a means of stimulating a lackluster economy.

Comparison Of U.S. Government Bonds
To Foreign Governments
(Basis Point Difference)

	1 Year		10 Year	
	May '90	*May '89*	*May '90*	*May '89*
Canadian	516	226	223	113
W. German	70	-182	-12	-182
U.K.	600	314	329	132
Swiss*	-170	-336	-235	-339
Dutch	82	-160	22	-145
French	126	-32	65	-11
Australian	641	622	487	477

*3 year; 1 year not available

Source: Salomon Brothers Inc

A review of the holdings of foreign securities by Japanese investors is also enlightening. At the end of 1984, Japanese investors held nearly $54 billion of foreign securities. The most recently available data (April 1990) shows holdings at $401.8 billion, a seven-fold increase. Of note, however, is that this is actually a decline from the $420 billion at year-end 1989. The reduction in holdings is a direct function of the declining value of the dollar and reinforces the substantial currency risk which Japanese investors have been subject to in the 1980s. Moreover, in 1984, before the Yen/Dollar Agreement had made its full impact, only 9% of Japanese securities holdings were foreign. In slightly over three years, this ratio had more than doubled to 18.6%. Since then, however, this ratio has remained more or less constant. For example, at the end of April 1990, this ratio had actually fallen to 18.2%. We suspect that due to the rapid accumulation of foreign equities and bonds that it is likely Japanese investors are growing comfortable with the ratio of foreign securities in their investment portfolios.

We have often expressed the view that foreign investment benefits both the U.S. and world economy. In the same vein, we have argued that attacks on foreign investment, which often border on the xenophobic, seem to be a clever way to avoid what must be done -- cuts in government spending and implementing tax policies that encourage savings. However, with concern over U.S. economic priorities given short shrift, those who have railed against foreign investment may finally have to confront U.S. economic realities.

David G. Strongin
Director,
International Finance